

BDG Business Valuation Insight

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Can goodwill hold up in a bad economy?

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Can goodwill hold up in a bad economy?

The recession isn't affecting just public finance firms and automakers. Across the board, demand is down, costs are up and credit is tight. Privately owned companies cannot escape the effects of a slowed economy, either. Among those effects is the possibility of impaired values.

A new standard?

Along with their publicly traded counterparts, private business owners need to consider the possibility that goodwill and other indefinite-lived intangible assets — as well as long-lived assets — may have declined in value. Impaired values might require corrective action to conform with Generally Accepted Accounting Principles (GAAP).

Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, has helped focus the spotlight on impairment testing. Effective in 2009, the new standard clarifies that fair value is an exit price determined by “market participants.” It prohibits companies from considering entity-specific synergies when estimating fair value.

These rule changes also could inadvertently cause impairment write-offs, as companies re-evaluate earlier goodwill assessments.

What is goodwill?

Any discussion of impairment requires some background. When a business merges with or acquires another entity, SFAS 141(R), *Business Combinations*, requires the acquirer to allocate the purchase price among the assets acquired and liabilities assumed, based on their fair values. If the purchase price is higher than the combined fair value of the acquired business's identifiable net assets, the excess value is labeled as goodwill.

Goodwill is then allocated among the reporting units (or operating segments) that it benefits. Many small private companies consist of a single reporting unit. But large conglomerates may be composed of numerous reporting units.

Purchase price allocations require valuation expertise. Before lumping excess value into goodwill, acquirers must identify or value other identifiable intangible assets, such



Make purchase price allocations a priority

Effective for deals closing in fiscal years beginning after Dec. 15, 2008, Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS) No. 141(R), *Business Combinations*, should be a forethought, not an afterthought. Like it or not, a company involved in a merger or acquisition must comply with SFAS 141(R) if its financial statements are to conform to Generally Accepted Accounting Principles (GAAP).

SFAS 141(R) changes the rules for purchase price allocations. For example, the revised rule requires companies to capitalize in-process research and development (IPR&D) costs as an indefinite-lived intangible asset. Once developed, IPR&D is assigned a value and a useful life over which to amortize its value. Additionally, SFAS 141(R) requires companies to record contingent assets and liabilities — including earnouts — on the acquisition date.

Proactive companies forecast how a transaction will affect their financial statements *before* the deal closes. Preacquisition valuations and purchase price allocations provide an extra level of merger-and-acquisition due diligence. They answer the question: "Does this purchase price make sense?" In fact, some acquirers revise deal terms — or walk away from a deal — after analyzing its probable effect on earnings.

Accounting for business combinations is more challenging than ever and requires outside appraisal expertise.

as trademarks, customer lists, copyrights, leases, patents or franchise agreements. An intangible asset is recognized apart from goodwill if it arises from contractual or legal rights — or if it can be sold, transferred, licensed, rented or exchanged.

Some intangible assets are assigned useful lives over which they are amortized. Other intangibles, such as goodwill, brand names and trademarks, may continue to provide value indefinitely.

How to test for impairment

In lieu of annual amortization write-offs, SFAS 142, *Goodwill and Other Intangible Assets*, requires companies to annually test goodwill and other indefinite-lived intangibles for impairment. More frequent impairment tests might be necessary if other triggering events — such as the loss of a key person, unanticipated competition, business reorganization or adverse regulatory actions — occur during the year.

Impairment testing is a two-step process:

1. An appraiser compares each reporting unit's fair value to its carrying value, which is the amount that shows up as the book value of equity if the reporting unit has a balance sheet. If the whole reporting unit's fair value exceeds its carrying value, no impairment has occurred and testing stops.
2. If the carrying value exceeds the reporting unit's fair value, the appraiser estimates the "implied" value of goodwill. SFAS 142 states that goodwill cannot be measured directly. So, to arrive at the implied value of goodwill, the appraiser allocates the reporting unit's fair

value to its identifiable assets and liabilities (including any "home-grown" intangible assets that aren't currently reported on the reporting unit's balance sheet). Any amount left over equals the implied value of goodwill.

Step 2 is similar to a purchase price allocation under SFAS 141(R), except that appraisers use the reporting unit's fair value in lieu of the purchase price. This hypothetical value allocation is just for impairment testing purposes. It doesn't change the carrying value of any other asset or liability on the balance sheet.

If the purchase price is higher than the combined fair value of the acquired business's identifiable net assets, the excess value is labeled as goodwill.

To the extent that the carrying value of goodwill exceeds its implied value, impairment has occurred. A company cannot recoup impairment losses or increase the value of an impaired asset in subsequent accounting periods. On the balance sheet, impairment is permanent.

In addition, a company must complete impairment testing on other assets — including its indefinite-lived intangibles and long-lived tangibles — *before* quantifying goodwill impairment.

